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THE UNITED KINGDOM AS AN EXPORTER OF CAPITAL

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THE United Kingdom has traditionally been a substantial exporter of long-term capital. In the nineteenth century no other country loaned nearly so much abroad to so many for so long. And even into the 1920's the London capital market was still a prime source of external finance. In the decades since the Great Depression, however, dramatic changes have occurred in Britain's position as a capital exporter. The purpose of this paper is to review some of these more recent developments.

The paper will concentrate on the period since 1952, and in particular on the years since 1958.¹ Admittedly, this is a short focus; a longer perspective might have been preferable. But unfortunately we are constrained by data inadequacies. Until 1952 no separate statistics exist for private long-term movements, these being lumped together with miscellaneous official long-term capital, nonreserve short-term movements, and the so-called "balancing item" (errors and omissions). Moreover, even though separate estimates of private capital flows have been published since 1952, those published before 1958 are not necessarily very accurate or complete. Only since 1958 are there comprehensive, detailed, and reliable data on both official and private long-term capital movements.

The paper will be divided into two parts. Part I will consider changes in the magnitude, direction, and composition of British capital exports since 1952. Here I shall argue that the main impact of these

NOTE: The author was affiliated with Princeton University at the time of the conference.

¹ The period prior to 1952 is already covered by an extensive literature, including in particular A. K. Cairncross, *Home and Foreign Investment, 1870-1913*, Cambridge, Mass., 1953; A. H. Imlah, *Economic Elements in the Pax Britannica*, Cambridge, Mass., 1958; E. V. Morgan, *Studies in British Financial Policy, 1914-25*, London, 1952; and United Nations, *International Capital Movements During the Inter-War Period*, Lake Success, N.Y., 1949.

developments has been to begin a transformation of the United Kingdom from its role as an originator of funds to essentially that of entrepôt. Part 2 will then take up some aspects of the recent history of official British capital controls. Here I shall argue that so far as Britain is concerned, capital restriction is a cheaper means of adjusting the balance of payments than either trade restriction or domestic demand management (expenditure reduction), which in the short term (given a decision to maintain a fixed rate of exchange) are the other policy alternatives commonly relied upon by the British authorities.

1

AN ENTREPÔT

Since 1952 Britain has exported capital regularly and in fairly substantial volume. But as compared with earlier periods of sizable British net investment abroad—specifically, the gold-standard era and the 1920's—significant changes have occurred. First, in relative terms the scale of capital exports has been much reduced. Secondly, the geographic pattern of lending has become much more concentrated than previously, outflows now being directed primarily toward the sterling area; vis-à-vis nonsterling areas, capital is now imported on balance. And finally, the composition of lending has altered radically. Portfolio investment, traditionally the commonest form of lending abroad, has declined in favor. Today it is subordinated to official capital flows (including grants as well as loans), and to direct investment, where British residents have a controlling interest in the foreign operation.

The implication of all these changes is that the United Kingdom is ceasing to be of much importance as a *source* of net capital exports. Today it is much less a provider of funds than it is a processor. Essentially, it is becoming an *intermediary*—an entrepôt for long-term investments. Britain has long functioned as a clearing bank at the short-term end of the market. Now, increasingly, at the long-term end, it is functioning as an investment bank as well.

Although short-term financial markets are not the subject of this paper, it would not be inapposite at this point to remind the reader briefly of what recently has been happening there. Basically, over the last decade or so, Britain has developed almost exclusively into the role of middleman. The role is formalized institutionally in the Euro-dollar market which, although extraterritorial and international, happens to be centered functionally in the City of London, where the largest part of its business is done. The City does not provide its own funds in the Eurodollar market; what it does provide is the flexibility and expertise of its financial institutions. It processes and adapts other people's money to be used by other people. It is a fixer—a clearing bank in the classic sense, taking deposits and lending, but venturing little of its own capital.

In a similar fashion, this seems to be happening in the long-term sphere as well, albeit rather less formally and rather more slowly. The major theme of this paper is that the United Kingdom is developing almost exclusively into a middleman in capital markets, too. Once the country was an international investor; now, primarily, it is becoming an international investment banker. The change may be seen in the comparatively narrow margin between gross long-term outflows and gross long-term inflows, especially in recent years. It may be seen as well in the increasing dependence of long-term outflows on short-term inflows (net): little of Britain's net capital export today is transferred in the form of real goods and services; the country, more and more, must borrow short in order to lend long. The change may also be seen in the geographic pattern of net outflows to sterling-area countries offset to a considerable extent by net inflows from nonsterling areas. And, most obviously, it may be seen in the thriving international bond (Eurobond) market, where for long-term portfolio investors the City now performs precisely the same function it does for short-term depositors and borrowers in the Eurodollar market—namely, the function of fixer. All of these developments appear to point in the same direction, toward the conclusion that I have suggested.

TABLE I
Summary of British Long-Term Capital Movements, 1952-68
(£ million)

	Official Movements			Private Movements			Over-all Movements		
	Grants & Loans by U.K. ^a	Grants & Loans to U.K. ^b	Net Outward Movement	Investment Abroad	Investment in U.K.	Net Investment Abroad	Out-flow	In-flow	Net Capital Exports
1952	66	104	-38	127	13	114	193	117	76
1953	53	65	-12	173	28	145	226	93	133
1954	39	-3	42	238	75	163	277	72	205
1955	84	-1	85	182	122	60	266	121	145
1956	71	-44	115	258	139	119	329	95	234
1957	68	80	-12	298	126	172	366	206	160
1958	67	-57	124	310	164	146	377	107	270
1959	60	-146	206	303	172	131	363	26	337
1960	125	-72	197	322	233	89	447	161	286
1961	99	-64	163	313	426	-113	412	362	50
1962	181	-44	225	242	248	-6	423	204	219
1963	192	-45	237	320	276	44	512	231	281
1964	243	-36	279	399	152	247	642	116	526
1965	246	-16	262	354	237	117	600	221	379
1966	263	3	260	304	272	32	567	275	292
1967	267	22	245	457	380	77	724	402	322
1968	211	54	157	736	573	163	947	627	320

SOURCE: *United Kingdom Balance of Payments*, selected issues.

^a Loans net of repayments; also includes British government subscriptions and contributions to international organizations, and other British official long-term capital (net).

^b Loans net of repayments.

MAGNITUDE

British capital movements since 1952 are summarized in Table 1. Official movements differ from the published statistics in that they include grants as well as intergovernment loans (net of repayment) and other official long-term capital. In most years, repayments by the government of the United Kingdom on previous loans from abroad

have exceeded new loans received. Private movements include net overseas investment by British residents (direct plus portfolio) less net investment by foreigners in the United Kingdom. Over-all movements are recorded in the final three columns of the table.

On balance, Britain exported capital in every year between 1952 and 1968, at an average over-all rate of some £250 million per annum. In certain years net capital exports were diminished because of unusual inflows of funds—as in 1952 and 1953, for instance, when more than £220 million of defense aid was received from the United States government. Likewise, in 1957 and again in 1966–68 there were large special credits totalling some £325 million from the United States Export-Import Bank for the purchase of American military aircraft and missiles, and in 1961 there was a £132 million increase in the foreign private-investment figure for the United Kingdom, reflecting the Ford Motor Company purchase of locally held shares in its British subsidiary. If these extraordinary inflows are excluded, the average over-all rate of British capital exports was really in the vicinity of some £290 million per annum.

Figures like these are impressive. The scale of British grants and investment abroad certainly has been substantial—indeed, in absolute terms, more substantial than either under the gold standard or during the 1920's. But we must keep such numbers in perspective. In relative terms British foreign lending is much less important than it ever was before the Great Depression. Prior to 1930 net capital exports, as a proportion of national income, tended as a rule to fluctuate in a fairly regular cyclical fashion, between 1 per cent of the gross national product at the bottom of the cycle and 6–7 per cent at the peak.² Since 1952, by contrast, net capital exports have accounted for hardly more than 1 per cent of the gross national product of the United Kingdom.

To be sure, net capital exports did accelerate rapidly over the period in review. During the 1950's the average rate of outflow was only £195 million a year (£235 million if extraordinary inflows are excluded), whereas during the 1960's it was higher, at £300 million a year (£340 million if extraordinary inflows are excluded). This reflected a substantial increase in the average rate of gross outflows of capital, from £300 million a year in the 1950's to £585 million in the

² Alexander G. Kemp, "Long-Term Capital Movements," in D. J. Robertson and L. C. Hunter, eds., *The British Balance of Payments*, London, 1966, p. 137.

1960's. But this increase was not out of line with the growth of the British economy in general or of its total foreign trade: in relation to the gross national product and visible trade, capital exports did not rise significantly. On the other hand, there did happen to be a large rise in gross long-term inflows between 1952 and 1968. Consequently, over the period as a whole, net capital exports as a percentage of gross capital exports actually fell—from roughly two-thirds in the 1950's to only about one-half in the 1960's. This emphasizes the evolving transformation of Britain's capital function from investor to investment banker: today, half of the country's gross investment abroad is based on someone else's money.

Why is there now such a narrow margin between gross outflows of long-term funds from the United Kingdom and gross inflows? Why has the country ceased to be of much importance as a source of net capital exports? One is tempted to suggest that it is because of the stringency of exchange-control regulations: relax the restrictions and lending is sure to increase. But such an answer obviously would be naive, confusing cause and effect. Certainly British exchange controls are tight, but they are tight precisely because, given its present economic behavior, the country cannot increase its net foreign lending. Britain presently absorbs far too large a proportion of its current income for its own purposes—for private and public consumption and for home investment. Not enough is left to invest abroad. In brief, there is no *exportable surplus*. The only way to increase net capital exports is to increase the exportable surplus—that is, to reduce real domestic absorption relative to real national income—but so far no postwar British government has been able to figure out how to do this.

For evidence of the narrowness of the capacity for foreign lending, we may consider net capital exports specifically in relation to the other major categories of the balance of payments—the balance of current transactions and the balance of monetary movements. These are shown in Table 2.³ The former balance (assuming it is in surplus) is an indication of the extent to which the net export of financial capital

³ In the table, the balance of current transactions as recorded in British statistics is adjusted to exclude net official transfers, which for our purposes are included in net capital exports. The balance of monetary movements is adjusted to include the "balancing item" (errors and omissions), on the grounds that this item reflects mainly unrecorded flows of short-term funds.

TABLE 2
 Long-Term Capital Exports, Current Balance, and Monetary Movements
 in the British Balance of Payments, 1952-68
 (£ million)

	Net Long-Term Capital Exports	Balance of Current Transactions (deficit -)	Balance of Monetary Movements plus "Balancing Item" (deficit -) ^a
1952	76	112	36
1953	133	90	-43
1954	205	135	-70
1955	145	-132	-277
1956	234	255	21
1957	160	287	127
1958	270	418	148
1959	337	225	-112
1960	286	-171	-457
1961	50	114	64
1962	219	233	14
1963	281	246	-35
1964	526	-218	-744
1965	379	127	-252
1966	292	244	-48
1967	322	-95	-417
1968	320	-87	-407

SOURCE: *United Kingdom Balance of Payments*, selected issues.

^a Represents the excess (net) of the second column over the first column.

is translated into a genuine transfer of capital—a movement of real goods and services. The latter is an indication of the extent to which, in a macroeconomic sense, the net outflow represents merely an exchange of one type of asset or liability for another—short-term borrowing (net) for long-term lending. It can be seen from the table that throughout the 1950's, and even as late as 1963, British capital exports, though small, were at least generally transferred successfully. Except

for 1955 and 1961, the current account was continuously in surplus, often by considerable amounts. Over the period as a whole the cumulative net outflow of real goods and services accounted for more than two-thirds of the net export of financial capital. After 1963, by contrast, the balance of payments was in almost continuous crisis, and the current account recorded a cumulative deficit of near-record proportions (for peacetime). Net long-term foreign lending was thus based entirely on net short-term borrowing from abroad—in other words, once again, on someone else's money. Overseas short-term borrowing mainly took the form of accumulation of liquid liabilities rather than liquidation of short-term assets.⁴

DIRECTION

Britain's developing role as an intermediary in capital markets is emphasized too by the geographic pattern of long-term inflows and outflows. Detailed statistics on the direction of capital movements were not available before 1958. However, since then a clear pattern has been evident: net outflows to sterling-area countries are offset to a considerable extent by net inflows from nonsterling areas (Table 3). This is a pattern reinforced and encouraged by British exchange-control regulations, which make a sharp distinction between sterling-area countries (the so-called "scheduled territories") and others. Restrictions on capital exports have been in operation since 1939. But traditionally restrictions have not been applied to the bloc of countries which (in addition to maintaining a portion of their reserves in London) enforce a system of controls similar to Britain's. In effect, exchange regulation operates around the whole group of sterling-associated countries rather than around the United Kingdom alone; within the group, relative freedom of investment prevails.⁵ It should

⁴ Between 1962 (the first year for which such data are available) and 1968, while Britain's total long-term assets rose by £5 billion, liquid liabilities increased by more than £9 billion, from roughly 70 per cent of the sum of long-term assets to over 100 per cent. Short-term assets meanwhile rose by just over £7 billion, and long-term liabilities by a little more than £2 billion. "An Inventory of U.K. External Assets and Liabilities: End-1968," *Bank of England Quarterly Bulletin*, December, 1969, pp. 444-445.

⁵ This is what first defined the sterling area formally as a legal entity. During the 1930's it had not been much more than an arrangement de convenance, an informal

TABLE 3
 Direction of Long-Term Capital Exports, 1958-68
 (£ million)

	All Areas			Overseas Sterling Area			Nonsterling Areas		
	Offi- cial	Pri- vate	Total	Offi- cial	Pri- vate	Total	Offi- cial	Pri- vate	Total
1958	124	146	270	94	200	294	30	-54	-24
1959	206	131	337	120	135	255	86	-4	82
1960	197	89	286	125	175	300	72	-86	-14
1961	163	-113	50	166	134	300	-3	-247	-250
1962	225	-6	219	145	130	275	80	-136	-56
1963	237	44	281	150	149	299	87	-105	-18
1964	279	247	526	192	218	410	87	29	116
1965	262	117	379	174	254	428	88	-137	-49
1966	260	32	292	182	174	356	78	-142	-64
1967	245	77	322	186	223	409	59	-146	-87
1968	157	163	320	181	324	505	-24	-161	-185

SOURCE: *United Kingdom Balance of Payments*, selected issues.

not be surprising, therefore, that British capital outflows over the years have tended to be mainly concentrated within the sterling area itself.

In fact, outflows to the sterling area have been sizable, averaging almost £290 million a year in 1958-63, and rising to more than £410 million a year thereafter. The rise reflects principally an increase of private investment outflows; United Kingdom government grants and loans (net of repayments) in the sterling bloc have held relatively steady since about 1964. But at the same time inflows from nonsterling areas have also been sizable, reflecting a high rate of both portfolio and

grouping of countries with close commercial and financial connections. But from 1939 on, it became a formal monetary region defined technically by British exchange-control regulations. In recent years some restriction has been imposed on capital transfers even within the sterling area. See below. For a valuable survey of British exchange controls over the years, see "The U.K. Exchange Control: A Short History," *Bank of England Quarterly Bulletin*, September, 1967, pp. 245-260.

direct investment in the United Kingdom, particularly from the United States. (Net inflows would have been even larger but for the British government's need to meet the annual installments on Canadian and American postwar loans.) It is evident that British capital exports over-all would be much smaller were it not for this steady net inflow of funds from nonsterling sources.

COMPOSITION

Regarding the composition of inflows and outflows, the most striking development recently is the rise to prominence of *official capital movements*. Except during the two world wars, the British government did not take much hand directly in the import or export of capital; that was the province of private borrowers and lenders. Traditions change, however, and in the postwar period the government itself has become a prime mover of long-term funds. While private capital exports have been held down by exchange restrictions, public capital exports have burgeoned. In fact, the change has been swift. As late as just a decade ago, official outflows still accounted for only about one-third of Britain's net capital exports, and private outflows for two-thirds. But in the last decade positions have been rapidly reversed; today, official outflows account for 80 per cent or more of the net total, private outflows for under 20 per cent (Table 1).

The details of official capital movements are summarized in Table 4. The role played by grants is outstanding. In the early 1950's, inward transfers were large enough to produce over-all net inflows of public funds; in the 1960's, outward transfers have been sufficient to explain the sharp rise of over-all outflows. Grants received by the British government between 1952 and 1958 consisted almost entirely of defense aid from the United States. Grants by the United Kingdom government, on the other hand, have been largely for economic rather than military purposes: for bilateral economic assistance plus subscriptions and contributions to international aid organizations. United Kingdom government loans likewise have been largely in connection with the British foreign-aid program. Loans to the United Kingdom government have been unimportant, apart from the Export-Import

TABLE 4
 Official Long-Term Capital Movements, 1952-68
 (£ million)

	Outflows				Inflows			Net Out- ward Move- ment
	Grants	Loans (net of repay- ments)	Other (net) ^a	Total	Grants	Loans (net of repay- ments)	Total	
1952	62	-16	20	66	120	-16	104	-38
1953	61	-27	19	53	122	-57	65	-12
1954	65	-34	8	39	51	-54	-3	42
1955	70	4	10	84	47	-48	-1	85
1956	73	-20	18	71	26	-70	-44	115
1957	75	-16	9	68	21	59	80	-12
1958	77	-16	6	67	3	-60	-57	124
1959	82	-28	6	60	-	-146	-146	206
1960	94	20	11	125	-	-72	-72	197
1961	118	-48	29	99	-	-64	-64	163
1962	121	47	13	181	-	-44	-44	225
1963	132	52	8	192	-	-45	-45	237
1964	163	65	15	243	-	-36	-36	279
1965	177	50	19	246	-	-16	-16	262
1966	180	64	19	263	-	3	3	260
1967	188	61	18	267	-	22	22	245
1968	178	60	-27	211	-	54	54	157

SOURCE: *United Kingdom Balance of Payments*, selected issues.

^a Includes subscription and contributions to international organizations, and other United Kingdom official long-term capital (net).

Bank credits for military purchases in 1957 and 1966-68; in all other years since 1952 repayments on previous loans have exceeded new loans received.

After stagnating throughout most of the 1950's, the British foreign-aid program accelerated rapidly following the 1958 Commonwealth Economic Conference in Ottawa. In response to pressures from less

developed Commonwealth members, the United Kingdom pledged to expand its aid effort—and expand it did. Between 1959 and 1964 development grants and loans each were approximately doubled in volume.⁶ However, after 1964 a new stagnation set in, albeit on a higher plateau than previously, owing to the crisis of the balance of payments. There has been little further increase in the program, despite the fact that virtually all aid today is tied to the purchase of British goods and services, either customarily (as in the case of dependent territories) or by regulation. According to one estimate, taking “switching” into account, the “flowback” to British exports amounted to nearly three-fifths of Britain’s bilateral aid (net of repayments) in 1963.⁷ For political reasons practically all of Britain’s bilateral aid goes to sterling-area countries. The main recipients include India and Pakistan (which between them get about one-quarter of all British economic assistance) and the former colonies of East and Central Africa.

Private capital movements in recent years have been dominated by direct investment flows. Detailed statistics on the composition of private capital movements were not available before 1958. The data since then are summarized in Table 5. They show that direct investments accounted for almost two-thirds of the total of net private investment in either direction between 1958 and 1968. And indeed, the actual fraction was probably even higher than that—perhaps as high as three-quarters, possibly even as high as four-fifths—since “other” investments in the British statistics include investments by the oil companies. These are known to be large, and are thought to be mainly direct investments rather than portfolio.

The reasons for the relative dominance of direct investment in private capital movements are not difficult to discover. As far as outward movements are concerned, the principal explanation seems to lie in the differential severity of Britain’s exchange-control regulations.

⁶ The apparent increase of loans in Table 4 is exaggerated owing to substantial loan repayments by Germany and France (averaging £65 million a year in 1959–61), which terminated after 1961. The increase of gross loans between 1959 and 1964 was from £48 million to £85 million. The figures in the table are not adjusted for interest payments on Britain’s development loans, which averaged nearly £25 million a year in 1963–65. Ministry of Overseas Development, *British Aid: Statistics of Official Economic Aid to Developing Countries*, London, 1967.

⁷ Andrzej Krassowski, “Aid and the British Balance of Payments.” *Moorgate and Wall Street*, Spring, 1965, p. 32.

TABLE 5
Private Long-Term Capital Movements, 1958-68
(£ million)

	Investments Abroad				Investments in U.K.				Net Outward Movement
	Di-rect ^a	Port-folio	Other (oil & misc.)	Total	Di-rect ^a	Port-folio	Other (oil & misc.)	Total	
1958	144	166	^b	310	87	77	^b	164	146
1959	196	107	^b	303	146	26	^b	172	131
1960	250	-37	109	322	135	43	55	233	89
1961	226	-28	115	313	236	115	75	426	-113
1962	209	-39	72	242	130	61	57	248	-6
1963	236	5	79	320	160	19	97	276	44
1964	263	3	133	399	162	-39	29	152	247
1965	308	-94	140	354	197	-46	86	237	117
1966	276	-82	110	304	195	-59	136	272	32
1967	281	52	124	457	170	11	199	380	77
1968	429	218	89	736	245	87	241	573	163

SOURCE: *United Kingdom Balance of Payments*, selected issues.

^a Excluding oil and, before 1963, insurance.

^b Included in portfolio investment.

Portfolio outflows have traditionally been restricted more tightly than direct-investment outflows (even though the latter, unlike the former, are subject to administrative control). As far as inward movements are concerned, the principal explanation seems to lie in the uncertainty regarding the sterling exchange rate. Portfolio investors are discouraged by the risk of potential devaluation or a floating rate. Direct investors, meanwhile, are encouraged by the general expansion of the British economy, and also, it has been suggested, by "the relative inefficiency of British entrepreneurs either in discovering investment opportunities or in translating them in practice."⁸

Between 1958 and 1968 the rate of direct investment in the United

⁸ A. G. Kemp, *op. cit.*, p. 149.

Kingdom as well as of direct investment abroad (both excluding the oil industry) virtually tripled. However, it is interesting to note that the increases of investment have not been matched by correspondingly large increases of funds actually flowing into or out of the country. British statistics (unlike those of the United States) define "direct investment" in either direction to include the parent company's share of the unremitted profits of overseas subsidiaries that are retained for reinvestment (a contra item being entered additionally in the current account opposite "direct investment income"). As it happens, unremitted profits have accounted for a rising proportion of the recorded investment totals: in 1958 they comprised half of the total in either direction; a decade later, some two-thirds. Thus, in absolute terms, outward investment other than unremitted profits is more or less unchanged from what it was in the late 1950's (undoubtedly reflecting the stringency of British exchange restriction) and inward investment has grown only moderately.

About 55 per cent of British direct investment abroad (whether or not unremitted profits are included) is in the sterling area, about 45 per cent in nonsterling areas. By far the largest share of total investment (two-thirds to three-quarters) goes to developed rather than to developing areas—the biggest beneficiaries being rapidly growing economies such as (within the sterling area) Australia and South Africa, and (outside the sterling area) the United States, Canada, and the countries of the Common Market. Virtually all of the foreign direct investment in the United Kingdom comes from nonsterling sources, in particular from the United States. Manufacturing accounts for well over half of the total movement in either direction.⁹

Portfolio movements in recent years have resulted in net inflows of investment funds into Britain. Apart from the years immediately preceding devaluation, foreign investors have bought sterling securities on balance, including both corporate and government issues. The pound is still widely regarded as a convenient international store of value. British investors, conversely, have tended steadily to liquidate foreign security holdings on balance, except during the period immedi-

⁹ For details on these and other aspects of direct investment in and out of the United Kingdom, see the successive articles on overseas investments in *Board of Trade Journal*, June 30, 1967; July 19, 1968; and May 9, 1969.

ately following devaluation. New purchases abroad are effectively discouraged by the obligation that they go through the so-called "investment-dollar market"; the requisite foreign exchange can only be obtained from the proceeds of new sales of foreign securities by British residents. Lately the premium on investment dollars has sometimes been as high as 50 per cent over the official exchange rate. New sterling issues in the London capital market have been insignificant, averaging (after redemptions) no more than £5 million a year. Only sterling-area and (since 1963) European Free Trade Association borrowers are permitted to float new sterling issues in London, and even they must take their place on the queue and wait their turn.

However, this does not mean that British financial institutions have been shut out of the business of foreign securities issues. Quite the opposite, in fact. Nothing better illustrates Britain's evolving transformation from investor to investment banker than the change in the capital function of the City of London. British financial institutions have been leaders in the development of the new market for "international" bonds (Eurobonds), issues arranged by international underwriting syndicates for sale in a number of different countries. The market began only in 1963 when, with the imposition of the United States Interest Equalization Tax effectively closing the New York capital market to foreign borrowers, several London merchant banks responded by organizing a series of foreign dollar loans. Since then the market has grown by leaps and bounds, from a mere \$137 million of new issues in 1963 (60 per cent denominated in dollars) to almost \$1.9 billion in 1967 (90 per cent in dollars) and to well over \$2 billion in 1968.¹⁰ And while the market's growing internationalization has inevitably diluted London's initial monopoly, the City still remains prominent in most underwriting syndicates; in fact, in the secondary market the City still remains predominant.¹¹ In short, British financial institutions play the classic role of middlemen, channeling foreign-owned funds to foreign borrowers, venturing none of their own capital. Indeed, that is precisely why currencies other than sterling were used

¹⁰ Bank for International Settlements, *Annual Report, 1968*, pp. 57-58.

¹¹ "The Eurodollar Market: What It Means for London," *The Banker*, 119, No. 522 (August, 1969), p. 777.

in the first place: direct British resident participation in the market was to be prevented.

2

AT several points in the course of this paper I have emphasized the importance of exchange-control regulations in shaping the magnitude, direction, and composition of British capital movements. However, by no means does this emphasis imply that a constant force has been in operation. In fact, there has been a marked ebb and flow in capital restriction since it was first introduced three decades ago. Control has been eased or augmented as the general balance-of-payments situation improved or deteriorated. During the war restriction was stringent, but as soon as the war ended steps were taken gradually to loosen control, paralleling the approach to convertibility on current account in December 1958. Conversely, since 1961, and especially since the beginning of the long payments crisis lasting from 1964, the trend has been back again toward an intensification of regulation. Today (early 1970), British capital restriction is probably as tight as it has ever been.

As one might expect, most of the intensification of regulation has affected investment outside the sterling area rather than inside it. Portfolio investment is now even more thoroughly discouraged than ever by a new requirement, dating from 1965, that 25 per cent of the proceeds from sales of foreign securities be sold in the official exchange market; only 75 per cent of proceeds are thus available for sale in the investment-dollar market. And direct investment has been handicapped by a series of new administrative rulings, dating from 1961, first setting stricter criteria for the eligibility of investments abroad; then obliging investors to obtain the requisite foreign exchange in the investment-dollar market at the current premium, rather than in the regular market at the official exchange rate. However, recently even within the sterling area investment has been affected. Relative freedom of portfolio investment still prevails.¹² But since 1966 direct

¹² The only important exception dates from 1957 when, in order to close the notorious Kuwait and Hong Kong "gaps," the authorities prohibited British purchases of non-

investment has been regulated by a so-called "voluntary" program to limit outflows toward what is officially described as the "developed" sterling area—defined as comprising Australia, Ireland, New Zealand, and South Africa. These are the members, of course, that account for the bulk of British investment within the bloc.

All of this does not leave much room for further restriction of capital exports. Even if at some point the authorities should need temporarily to turn another screw, they may well find it difficult to locate one—unless they are willing to contemplate a virtually complete embargo on new investments abroad. But even before that point is reached a prior consideration intervenes, at least insofar as the overseas sterling area is concerned: further restrictions could endanger the very foundations of Britain's monetary region. It is well known that the outer members' privileged access to British capital is one of the few frayed threads still holding the sterling bloc together:

The kernel of the sterling area arrangement, in so far as any arrangement formally exists, is a *quid pro quo*: that Britain should give the overseas sterling countries broadly free access to the London capital and money market, and impose no exchange control on outward payments to them—in exchange for which these countries will generally keep their external reserves at the Bank of England, rather than in dollars or in gold. . . .

The fear is that, if Britain ever rescinded its part of the bargain, the sterling area countries could cause massive disturbances by liquidating their balances in London and demanding dollars and gold that Britain could not pay.¹³

The fear of a run is a real one—and remains real despite the Basle reform of the sterling area announced in 1968, which provided members with an exchange guarantee of their sterling reserve balances.¹⁴ Sterling-area countries still regard their access to British capital as of the utmost importance. Andrew Shonfield's point has not lost its force: "The essential fact is that the sterling area has changed its

sterling securities from overseas sterling-area residents. See Peter B. Kenen, *British Monetary Policy and the Balance of Payments, 1951-1957*, Cambridge, Mass., 1960, pp. 150-152.

¹³ *The Economist*, February 19, 1966, p. 721.

¹⁴ *The Basle Facility and the Sterling Area* (Cmnd. 3787, October, 1968).

character. It has ceased to be an old-fashioned bank; its members now regard it as an investment fund."¹⁵ In 1966, following the announcement of the voluntary program affecting the developed sterling area, the fear of a run was almost realized. Many sterling-area countries saw the program as the thin edge of a wedge. One member, New Zealand, is reported to have made a definite threat to withdraw its reserves from London.¹⁶

Nevertheless, suppose the United Kingdom *must* temporarily turn another screw, postponing for a time further investments overseas. What is the direct income cost of capital restriction as a means of adjusting the balance of payments in the short-term?

To attempt an answer to this question, we may concentrate on direct investment outflows, since portfolio investments have on balance been in a process of liquidation, rather than increasing, in recent years. What is striking about direct investment is its apparently low level of relative profitability. Data compiled by several different authors all point to the same conclusion, that the average return on British direct investment overseas is at best only marginally higher than the after-tax rate of return on comparable investments at home.¹⁷ The most comprehensive study available is the *Report* by W. B. Reddaway. He found that the most important returns from foreign investment are those that accrue through the level of after-tax profits and through the net gain from "knowledge sharing" (knowledge of new techniques, new products, new methods of marketing, and so on). Together, after appropriate adjustment of depreciation rates and also after allowing for capital appreciation, these produce an operating return of just 6 per cent a year on the total of capital invested abroad, as compared with a domestic "opportunity" cost of at least 3 per cent a year. Thus the net amount of gain for Britain annually seems to be no more than approximately 3 per cent of the amount invested. Conversely, at

¹⁵ Andrew Shonfield, *British Economic Policy Since the War*, London, 1958, p. 128.

¹⁶ John Cooper, *A Suitable Case for Treatment: What to Do about the Balance of Payments*, London, 1968, p. 230.

¹⁷ See, e.g., John H. Dunning, "Further Thoughts on Foreign Investment," *Moorgate and Wall Street*, Autumn, 1966, pp. 24-26; Richard N. Cooper, "The Balance of Payments," in Richard E. Caves and Associates, *Britain's Economic Prospects*, Washington, 1968, pp. 175-176; and W. B. Reddaway in collaboration with S. J. Potter and C. T. Taylor, *Effects of U.K. Direct Investment Overseas: Final Report*, Cambridge, 1968, ch. 23-26, especially pp. 333-336.

most just 3 per cent a year is lost if overseas investments are temporarily restricted.¹⁸

Richard Cooper calculated the medium-term "trade-offs" for the United Kingdom between capital restriction and several alternative means of achieving a given improvement in the balance of payments. Assuming a decision to maintain a fixed rate of exchange, three of the trade-offs—for capital restriction, trade restriction, and domestic demand management (expenditure reduction)—are summarized in Table 6.¹⁹ To improve the balance of payments by £100 million when the exchange rate is fixed the authorities must reduce private capital outflows across-the-board by £112 million.²⁰ Alternatively, they must impose an import surcharge on manufacturers of 4 per cent, or generate a rise in unemployment of .34 percentage points. Table 6 also summarizes the direct annual cost of each of the three alternatives. (The calculations for trade restriction and domestic demand management are described in the appendix to this paper.) Capital restriction is by far the cheapest means of adjustment—3 per cent of the postponed investment, or just £3 million a year. Trade restriction is more expensive, some £45 million a year, and this is just a minimum estimate; the cost would be higher if the form of trade restriction chosen were more discriminatory than a uniform surcharge (say, differential levies or import quotas). Demand management is the costliest alternative of all—£245 million a year.

¹⁸ The key assumption here is that if investments abroad are temporarily restricted, they will not be lost irrevocably: they will simply be postponed for a time, until the balance-of-payments situation is reversed. Such an assumption is justified by the formulation of the problem in the text, as one of *short-term* adjustment. Britain's loss would of course be greater if, in a longer-term context, it were assumed that some investments would be lost irrevocably, rather than merely postponed.

¹⁹ Richard Cooper, *op. cit.*, p. 196.

²⁰ I have adjusted Cooper's calculation of this trade-off slightly. Cooper reckoned that for a payments improvement of £100 million, an across-the-board reduction of private capital outflows of £110 million would be required. This figure was based on Professor Reddaway's interim study of the effects of British overseas investment, published in 1967, which had estimated that for every £100 million of new capital outflow, British exports rise (on average) by about £9 million. (Thus, 91:100 = 100:110.) However, after Cooper wrote, Reddaway's *Final Report* (1968) increased the estimated rise of exports to £11 million. Cooper's calculation must therefore be increased to £112 million (89:100 = 100:112). Reddaway's studies also indicate that in the longer term, there will be a decline of balance-of-payments receipts equal to 4 per cent a year of the initial reduction of capital outflows. See W. B. Reddaway in collaboration with J. O. N. Perkins, S. J. Potter, and C. T. Taylor, *Effects of U.K. Direct Investment Overseas: An Interim Report*, Cambridge, 1967, p. 122; and Reddaway, *Final Report*, p. 342.

TABLE 6
Size and Cost of Alternative Methods of Improving the Balance of Payments
by £100 Million

Alternative Method	Specific Course of Action	Size of Policy Change ^a	Annual Cost
Capital restriction	Across-the-board reduction of private outflows ^b	£112 million	£3 million
Trade restriction	Import surcharges on manufacturers ^b	4 per cent	£45 million
Domestic demand management	Rise of unemployment rate	.34 percentage points	£245 million

SOURCES: Richard N. Cooper, "The Balance of Payments," in Richard E. Caves and Associates, *Britain's Economic Prospects*, Washington, 1968, p. 196; and text and Appendix.

^a Per year, in terms of transactions levels of 1966. "Medium-term" effects, after a period of adjustment.

^b Assumes no foreign retaliation.

The ranking of the three alternatives is about what we would expect on the basis of a priori theoretical considerations.²¹ The immense width of the range, however, is surprising. The loss from restriction of capital outflows is only one-fifteenth of the least cost resulting from trade restriction; and even the latter is rather slight as compared with the loss from domestic expenditure reduction. Clearly, the optimal course for Britain at times of short-term payments crisis, given a decision to maintain a fixed rate of exchange, has been first to postpone investments abroad. For this the government has been frequently criticized: many experts have argued that if the exchange rate itself cannot be changed, then domestic expenditure reduction would be far preferable to the imposition of restrictions or controls of any kind. But perhaps, the expectations of such experts to the contrary notwithstanding, the authorities have known what they were doing after all.

²¹ See, e.g., Richard N. Cooper, *The Economics of Interdependence: Economic Policy in the Atlantic Community*. New York, 1968, pp. 249-259.

APPENDIX

IN this appendix I describe my method of calculating the direct annual income-cost of trade restriction and of domestic demand management (expenditure reduction) as alternative means of adjusting the balance of payments in the short term when the exchange rate is fixed. In the text the results are summarized in Table 6.

DEMAND MANAGEMENT

Richard Cooper estimates that the trade-off between the unemployment rate and the payments balance is on the order of 0.1 additional percentage points of the former for roughly every £29 million improvement of the latter.²² For £100 million of improvement approximately .34 additional percentage points of unemployment would be required.

As a rule, short-term fluctuations in employment tend to understate the corresponding fluctuations in gross income and output. That is, in the short-term the rate of unemployment of labor typically varies by less than the corresponding rate of employment of total capacity. There are several reasons for this.²³ The most important explanation is that the rate of utilization of labor tends to change simultaneously. Some workers, in production as well as administration, are regarded by their employers as a kind of overhead: their number is neither reduced when there is a temporary decline in output, nor raised when there is a temporary increase; instead, they simply work at a more or less leisurely pace. Additional factors include changes in the length of the work week and changes in the number of marginal workers entering or leaving the labor force.

The precise relationship between unemployment and output is not easy to identify. Frank Paish has suggested that a variation in the rate of unemployment is associated with a variation in gross output (sign changed) multiplied by a factor of five.²⁴ However, this seems

²² Richard Cooper, "The Balance of Payments," pp. 156-162.

²³ See, e.g., *ibid.*, pp. 157-158; and F. W. Paish, *Studies in an Inflationary Economy*, New York, 1962, p. 318.

²⁴ *Ibid.*, p. 319.

an extraordinarily high figure; at any rate, Paish's evidence is sketchy and not very convincing. Much more complete and convincing is the evidence from two full-scale empirical investigations: one an international comparison by Brechling and O'Brien, the other a study of the United Kingdom by Godley and Shepherd.²⁵ Both sources produce a virtually identical estimate of a factor of two. That is, both agree that changes in gross output in Britain typically are about double the corresponding (opposite) changes in the rate of unemployment.

This means that an increase of .34 percentage points of unemployment will be associated with a loss of .68 per cent of real national output. In Britain in 1968 gross domestic product (which is the most comprehensive measure of the output of the economy) stood at £36,267 million. Approximately two-thirds of 1 per cent of that is some £245 million. This indicates the order of magnitude of national income that would have to be foregone (annual rate) if demand management were the alternative chosen to achieve an additional £100 million improvement of the balance of payments in the short term.

TRADE RESTRICTION

Despite a long tradition of liberal commercial policies, Britain in November 1964 unilaterally imposed a surcharge of 15 per cent on imports of most manufactured products, ostensibly for balance-of-payments purposes. Two years later (after having reduced the surcharge once, to 10 per cent, in April 1965) it was removed. There is still disagreement regarding the effectiveness of the surcharge. When first announced, it was expected to reduce imports by about £300 million a year. But according to the most systematic estimate to date, by Johnston and Henderson, imports were in fact probably reduced by only £156 million through the end of 1965, and by £72 million in 1966, both in terms of 1958 prices.²⁶ Converting to 1964 prices sug-

²⁵ Frank Brechling and Peter O'Brien, "Short-Run Fluctuations in Manufacturing Industries: An International Comparison," *Review of Economics and Statistics*, August, 1967, pp. 277-287; and W. A. H. Godley and J. R. Shepherd, "Long-Term Growth and Short-Term Policy," *National Institute Economic Review*, August, 1964, pp. 26-38. But cf. Richard N. Cooper, "The Balance of Payments," *op. cit.*, p. 160, n. 26.

²⁶ John Johnston and Margaret Henderson, "Assessing the Effects of the Import Surcharge," *Manchester School of Economic and Social Science*, May, 1967, pp. 89-110.

gests a reduction of £130 million during the year 1965 (excluding the last quarter of 1964, which is included in the £156 million) and of £80 million in 1966.²⁷

However, Johnston and Henderson probably underestimated the effectiveness of the surcharge, to the extent that the full amount of the tax was not reflected in the price paid in Britain for manufactured imports. The surcharge was known to be temporary. Accordingly, many foreign exporters, wanting to maintain their position in the British market, may have absorbed some of it themselves. As Richard Cooper points out, this possibility is supported by the fact that import unit values, which had been rising steadily during the several years before 1965, stopped rising in 1965 and 1966 despite continued price increases in exporting countries. By adjusting for this possibility Cooper increases the estimated effectiveness of the surcharge.²⁸ His calculation of the trade-off between a control of this kind and the payments balance (on the assumption of no direct foreign retaliation) is on the order of approximately 1 additional percentage point of the former for every £25 million improvement of the latter. For £100 million of improvement a surcharge of 4 per cent would be required.

A surcharge on this order—or, indeed, any trade control at all—is bound to create an incidental loss of efficiency by protecting import-competing industries. The misallocation of resources is the cost of the improvement in the balance of payments. The magnitude of the cost will depend on the flexibility of output and demand in the economy, on the structure of prior trade restrictions, and especially on the nature of the new trade restriction. In general, the more discriminatory barriers to imports are, the greater are the distortions that are introduced into the domestic price system. Conversely, the more uniform a new barrier is, the smaller is the loss of income that will ensue.²⁹ Britain's surcharge in 1964 was applied uniformly to virtually all imports competing with manufacturing industries at home. We may assume, therefore, that the cost of the surcharge, or of any control like it, represents broadly the *lower* limit of the range of potential efficiency losses from trade restriction.

²⁷ Richard N. Cooper, "The Balance of Payments," p. 167.

²⁸ *Ibid.*

²⁹ *Ibid.*, p. 252.

There has been surprisingly little empirical research by economists into the efficiency losses of trade restrictions. However, what little work has been done suggests that in developed economies such losses tend to be very small for uniform tariffs or surcharges—certainly lower than the corresponding losses of income that are necessitated by deflations of equivalent impact on the balance of payments.³⁰ At the theoretical level, this suggestion has been confirmed by Harry Johnson. Using a simplified but highly plausible model, he calculates

that both the total gains from international trade and the cost of protection are likely to be relatively small in the large advanced industrial countries, owing to their relatively flexible economic structures, probably high elasticities of substitution among the goods on which this consumption is concentrated, and relatively low natural dependence on trade.³¹

We can use Johnson's calculations to estimate the cost for Britain of a 4 per cent surcharge on manufactured imports. As it happens, the British do not have a relatively low natural dependence on trade; in fact, imports run at between 16 and 17 per cent of gross national product. But on the other hand, it happens that like other large advanced industrial countries, they do have a relatively high degree of flexibility in both output and demand. If we assume that the elasticities of substitution in production and consumption are each unity, we find that the efficiency loss created by a 4 per cent surcharge amounts to not more than 0.13 per cent of free-trade output.³² Of course, we have no idea what free-trade output might potentially be, but as an approximation we may instead take the most comprehensive statistical measure available of actual output—namely, gross domestic product. In 1968, 0.13 per cent of gross domestic product was roughly £45 million. This is indicative of the *minimum* amount of national income that would have to be foregone (annual rate) if a uniform surcharge

³⁰ *Ibid.*, pp. 249–252 and 257–259. Existing empirical work on the efficiency losses from trade restriction is summarized by Harvey Liebenstein, "Allocative Efficiency vs. 'X-Efficiency,'" *American Economic Review*, June, 1966, pp. 392–394.

³¹ Harry G. Johnson, "The Costs of Protection and Self-Sufficiency," *Quarterly Journal of Economics*, August, 1965, p. 371.

³² This is composed of a consumption cost of approximately 0.06 per cent (calculated from Johnson, Table IA, p. 361) and a production cost of approximately 0.07 per cent (from Table II, p. 365).

were the alternative chosen to achieve an additional £100 million improvement of the balance of payments in the short term. If more discriminatory forms of trade restriction were chosen (e.g., differential levies or import quotas), the cost would be correspondingly greater.

